

Message Text

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ACTION EA-12

INFO OCT-01 ISO-00 FEA-01 ERDA-05 AID-05 CEA-01
CIAE-00 COME-00 DODE-00 EB-08 FPC-01 H-01 INR-07
INT-05 L-03 NSAE-00 NSC-05 OMB-01 PM-05 USIA-06
OES-07 SP-02 SS-15 STR-05 TRSE-00 ACDA-12 /108 W
-----043483 210650Z /12

R 210430Z OCT 77
FM AMEMBASSY JAKARTA
TO SECSTATE WASHDC 4548
INFO AMCONSUL HONG KONG
AMCONSUL MEDAN
AMCONSUL SURABAYA

C O N F I D E N T I A L SECTION 1 OF 2 JAKARTA 14273

HONG KONG FOR TREASURY REP SHARPE

E.O. 11652: GDS
TAGS: ENRG, ID
SUBJECT: IRS RULING ON INDONESIAN PRODUCTION-SHARING CONTRACTS

REF: A) HONG KONG 12620, B) JAKARTA 13467, C) STATE 229513

1. SUMMARY: FOLLOWING IS LATEST UPDATE OF DEVELOPMENTS HERE CONCERNING IRS CONSOLIDATION ISSUE AND WE ALSO INCLUDE OUR COMMENTS IN REPSOONSE TO REFTEL A. EMBASSY HAS BEEN TOLD GOI NOW BELIEVES IRS IS ABOUT ISSUE RULING THAT WILL REQUIRE CONSOLIDATION AFTER JANUARY 1, 1978 IN ORDER FOR PRODUCTION-SHARING PAYMENTS QUALIFY AS TAX CREDITS IN US. INDICATIONS ARE GOI IS TRYING TO FASHION PRAGMATIC POLICY RESPONSE TO ANTICIPATED RULING THAT WOULD PERMIT CONTINUED FLOW OF FOREIGN INVESTMENT INTO INDONESIA'S HYDROCARBON SECTOR. HOWEVER, GOI IS ALSO CONCERNED ABOUT POSSIBLE SIGNIFICANT SHORT-TERM REVENUE LOSS FROM POLICY THAT ACCOMMODATES "CONSOLIDATION," INDONESIAN PLANNERS ARE REASSESSING LIKELY REVENUE EFFECTS OF CONSOLIDATION, BUT AT PRESENT HAVE NOT YET FOUND WAY
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TO AVOID WHAT THEY CLAIM WILL BE SIZEABLE SHORTFALLS IN OIL EARNINGS IN 1978 WITHOUT FURTHER DEPRESSING EXPLORATORY ACTIVITY IN OIL SECTOR. OIL REVENUE LOSS WOULD CUT DEEPLY INTO GOI DEVELOPMENT PROGRAM. END SUMMARY

2. IN REFTEL B WE ASSESSED OUTLOOK FOR INDONESIAN PETROLEUM SECTOR WITHOUT REFERRING TO POSSIBLE IMPACT

OF IRS DECISION CONCERNING TAX TREATMENT OF PAYMENTS UNDER PRODUCTION-SHARING CONTRACTS. WE DID SO BECAUSE AS REF C INDICATED, EFFECT OF IRS RULING IS DIFFICULT TO PREDICT AND BECAUSE SUBJECT HAS BEEN WILL COVERED IN PREVIOUS EMBASSY REPORTING AND WASHINGTON AWARE OF ITS IMPORTANCE.

3. HOWEVER, TREASURY ATTACHE SHARPE IS CORRECT IN STATING IRS DECISION IMPORTANT IN PROJECTING INDONESIAN OIL PRODUCTION AND EXPORTS. OUR DISCUSSIONS HERE INDICATE SOME US COMPANIES VIEW THIS ISSUE AS SIGNIFICANT RISK THAT COULD SUBJECT THEM TO DOUBLE TAXATION OR TO A NEW UNILATERAL REVISION OF CONTRACTS BY GOI. OTHER US COMPANIES SEE IRS DECISION AS OPPORTUNITY TO GAIN IMPORTANT NEW BENEFITS (CONSOLIDATION FOR TAX PURPOSES). THEY BELIEVE GOI WOULD HAVE TO ACCOMMODATE AN IRS RULING AND WOULD NOT ALLOW THEM TO BE SUBJECT TO DOUBLE TAXATION THAT COULD HALD EXPLORATORY ACTIVITY.

4. IN EMBASSY' S JUDGEMENT,AN IRS RULING ESSENTIALLY PERMITTING CONTINUATION OF STATUS QUO (PRODUCTION-SHARING PAYMENTS PERMITTED AS TEAX CREDITS IN US WITHOUT REQUIRING CONSOLIDATION IN INDONESIA) MIGHT BEING SOME MARGINAL INCREASE IN OIL COMPANY INVESTMENT SIMPLY AS RESULT OF ENDING ANY UNCERTAINTY ABOUT RULES OF GAME.

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5. ON OTHER HAND, EMBASSY BELIEVE S THAT IF IRS RULING REQUIRES CONSOLIDATION PRINCIPLE, THEN IMPACT ON PRODUCTION AND EXPORTS WILL BE LARGELY DETERMINED BY GOI RESPONSE. EMBASSY UNDERSTANDS GOI NOW BELIEVES IRS WILL SOON RULE THAT ALL PRODUCTION-SHARING PAYMENTS AFTER JANUARY 1, 1978 MUST BE BASED ON CONSOLIDATION PRINCIPLE IN ORDER TO QUALIFY AS TAX CREDITS UNDER US LAW. ACTING ON THIS BELIEF, GOI IS NOW IN PROCESS OF FORMULATING ITS RESPONSE. PRELIMINARY INDICATIONS ARE THAT A "PRAGMATIC" POLICY WILL EMERGE FROM DEBATE WITHING INDONESIAN GOVERNMENT, ALTHOUGH MORE POLITICALLY MOTIVATED RESPONSES ARE ALSO BEING ADVOCATED.

6. PERTAMINA PRESIDENT HARYONO TOLD EMBASSY OFFICER OCTOBER 17 THAT GOI IS DISMAYED AT PROSPECT OF IRS REQUIRING CONSOLIDATION, BUT THAT HE AND OTHERS BELIEVE INDONESIA WOULD HAVE TO MAKE THE BEST OF BAD SITUATION AND NOT EXACERBATE ROBLEM BY RESPONDING WITH POLICY OF POLITICAL CONFRONTATION.

7. HARYONO REITERATED WHAT HE SEES AS PROBLEMS TO

INDONESIA FROM PROSPECTIVE IRS RULING, INCLUDING
A) POSSIBBE SACRIFICE OF PRODUCTION-SHARING PRINCIPLE,
B) POSSIBLE SHORT-TERM LOSS OF SIGNIFICANT AMOUNT OF
REVENUE ALREADY COUNTED ON IN COUNTRY'S DEVELOPMENT
PLAN, C) ISSUE OF SOVEREIGN NATION BEING FORCED TO
REVISE AN IKNNOVATIVE AND SUCCESSFUL CONCEPT GOVERNING
FOREIGN INVESTMENT AS RESULT OF DECISION BY ANOTHER
COUNTRY'S TAX AUTHORITIES, AND D) POSSIBLE FOREIGN
POLICY EMBARRASSMENT TO INDONESIA WITH ITS ASEAN
NEIGHBORS IF TI ACQUIESCES IN IRS RULING.

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INT-05 L-03 NSAE-00 NSC-05 OMB-01 PM-05 USIA-06
OES-07 SP-02 SS-15 STR-05 TRSE-00 ACDA-12 /108 W
-----043388 210649Z /12

R 210430Z OCT 77

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C O N F I D E N T I A L SECTION 2 OF 2 JAKARTA 14273

HONG KONG FOR TREASURY REP SHARPE

8. HARYONO SIAD GOI HAS BEEN PUT IN BAD SITUATION AND
TOUGH DECISIONS WERE CALLED FOR. HE FAVORS REACHING
"PRAGMATIC" SOLUTION THAT WOULD NOT IMPAIR INDONESIA'S
ABILITY CONTINUE TO ATTRACT NEEDED FOREIGN INVESTMENT
IN HYDROCARBON SECTOR. HE SAID GOI HAS NOT YET DETER-
MINED ITS POLICY, BUT THAT FINANCE MINISTER WARDHANA
AND MINISTER OF STATE FOR ECONOMY WIDJOJO ARE NOW IN-
VOLVED IN DISCUSSIONS AS WELL AS SENIOR ENERGY
OFFICIALS. HARYONO FELT A PRACTICAL POLICY WOULD
EMERGE FROM GOI ALTHOUGH HE ADDED THAT SOME WOULD
PREFER A TOUGH POLITICAL RESPONSE TO AN ADVERSE RULING.

9. HARYONO DID NOT SPECULATE ON POSSIBLE SPECIFICES
OF A GOI POLICY BUT EMBASSY HAS LEARNED THAT ONE OPTION
BEING DISCUSSED WOULD REQUIRE NEW CONTRACT AREAS AFTER

JANUARY 1, 1978 BE GIVEN ONLY TO "COMPANIES" THAT DO NOT HAVE ANY OTHER CONTRACT AREAS IN INDONESIA. APPARENTLY MORE CONTROVERSIAL ISSUE IS HOW TO TREAT COMPANIES THAT CURRENTLY HAVE BOTHE PRODUCTING AND NON-PRODUCTING
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CONTRACT AREAS WHICH WOULD BE IMMEDIATELY AFFECTED BY CONSOLIDATION PRINCIPLE. ONE SUGGESTION IS TO REQUIRE THESE COMPANIES STOP ALL WORK IN NON-PRODUCTING AREAS ON JANUARY 1, 1978. THIS WOULD PRESERVE PRODUCTION-SHARING CONCEPT AT COST OF FURTHER DEPRESSING EXPLORATORY ACTIVITY. ALTERNATIVE SUGGESTION BEING DISCUSSED IS TO ACCEPT CONSOLIDATION IN THESE LIMITED CASES WHICH ALTHOUGH CAUSING SHARP DROP IN GOI REVENUES AND ERODING PRODUCTION-SHARING CONCEPT IN AFFECTED NON-PRODUCING AREAS WOULD ALSO PROVIDE INCENTIVES FOR INCREASED EXPLORATORY ACTIVITY IN THOSE SAME AREAS.

10. COMMENT: IF IRS RULING IS IMMINENT AND IF RULING CONFORMS TO GOI'S ASSUMPTIONS, THEN HARYONO'S COMMENTS MAY ONLY BE EARLY INDICATIONS OF WHAT MAY BE FAST-MOVING INTRA-GOI DEBATE ON THE SUBJECT, WITH POSSIBILITY OF MANY UPS AND DOWNS BEFORE FINAL DECISION IS REACHED. AT THIS PRESUMABLE EARLY STAGE IN GOI CONSIDERATION OF A POLICY RESPONSE, IT APPEARS PERTAMINA'S EMPHASIS WILL BE ON REACHING PRACTICAL SOLUTION THAT AT MINIMUM DOES NOT IMPAIR FLOW OF FOREIGN CAPITAL INTO INDONESIA'S HYDROCARBON SECTOR. EVEN HERE, THOUGH, THERE MAY BE PITFALLS WITH ATTITUDE OF COMPANIES AN IMPORTANT FACTOR. EMBASSY OFFICER WAS PRESENT AT DINNER DISCUSSION OF THIS ISSUE BETWEEN HARYONO AND UNION OIL PRESIDENT FRED HARTLEY IN WHICH HARTLEY EMPHASIZED OIL COMPANIES DO NOT INVEST HERE IN ORDER TO GET TAX CREDITS, BUT RATHER TO FIND OIL. HE ASKED HARYONO TO ACCEPT THE CONSOLIDATION PRINCIPLE AT LEAST FOR A TRIAL PERIOD BECAUSE HE CLAIMS IT COULD WELL INCREASE EXPLORATORY ACTIVITY AND EVENTUALLY PRODUCTION TO THE BENEFIT OF BOTH THE COMPANIES AND THE GOI. IN RESPONSE, HARYONO WAS LESS THAN ENTHUSIACTIC ABOUT POSSIBLE
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GOI'S ACCEPTANCE OF EVEN LIMITED CONSOLIDATION PRINCIPLE AND SOUGHT TO ENLIST HARTLEY'S ADVICE AS TO HOW INDONESIA MIGHT COOPERATE WITH COMPANIES TO AVOID SIZEABLE REVENUE LOSS. HARTLEY REPEATED EARLIER ASSERTION THAT CONSOLIDATION MIGHT WELL LEAD TO REVENUE

GAIN FOR INDONESIA OVER MEDIUM TERM. IN EMBASSY'S JUDGEMENT, GOI WILL SEEK TO MAINTAIN AT LEAST FIG LEAF OF RESPECTABILTY FOR PRODUCTION-SHARING CONCEPT, BUT BASIC ISSUE AS HARYONO/HARTLEY CONVERSATIONN INDICATED IS LIKELY TO BE REVENUE IMPLICATONS OF IRS RULING. WIDJOJO AND WARLHANA'S INVOLVEMENT IS NOT ONLY DUE TO THEIR PARAMOUNT POSITION AMONG INDONESIA'S TECHNOCRATS, BUT ALSO ENSURES THAT THOSE WHO DECIDE ON THE SPENDING OF INDONESIA'S OIL MONEY WILL BE HEARD AND PERHAPS DECISIVE IN THE GOI'S FINAL DECISION. EMBASSY HAS BEEN TOLD THAT INFORMAL PERTAMINA STUDY OF REVENUE EFFECT OF CONSOLIDATION CONCLUDES GOI WOULD HAVE LOST ABOUT \$500 MILLION IN 1976 IF CONSOLIDATION APPLIED TO THAT YEAR. GOI IS MAKING NEW ESTIMATES OF REVENUE IMPACT OF CONSOLIDATION BUT CURRENTLY SEES NO WAY TO AVOID SIZEABLE LOSS OF REVENUE OVER SORT TERM WITHOUT FURTHER DEPRESSING EXPLORATORY ACTIVITY. ANY DROP IN OIL REVENUES WOULD HAVE TO COME OUT OF GOI DEVELOPMENT BUDGET. RIVES

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Message Attributes

Automatic Decaptioning: X
Capture Date: 01-Jan-1994 12:00:00 am
Channel Indicators: n/a
Current Classification: UNCLASSIFIED
Concepts: PRODUCTION, TAX LAW, CONTRACTS, FOREIGN INVESTMENTS
Control Number: n/a
Copy: SINGLE
Sent Date: 21-Oct-1977 12:00:00 am
Decaption Date: 01-Jan-1960 12:00:00 am
Decaption Note:
Disposition Action: RELEASED
Disposition Approved on Date:
Disposition Case Number: n/a
Disposition Comment: 25 YEAR REVIEW
Disposition Date: 22 May 2009
Disposition Event:
Disposition History: n/a
Disposition Reason:
Disposition Remarks:
Document Number: 1977JAKART14273
Document Source: CORE
Document Unique ID: 00
Drafter: n/a
Enclosure: n/a
Executive Order: GS
Errors: N/A
Expiration:
Film Number: D770387-0386
Format: TEL
From: JAKARTA
Handling Restrictions: n/a
Image Path:
ISecure: 1
Legacy Key: link1977/newtext/t19771035/aaaabdcl.tel
Line Count: 243
Litigation Code IDs:
Litigation Codes:
Litigation History:
Locator: TEXT ON-LINE, ON MICROFILM
Message ID: f9c29c29-c288-dd11-92da-001cc4696bcc
Office: ACTION EA
Original Classification: CONFIDENTIAL
Original Handling Restrictions: n/a
Original Previous Classification: n/a
Original Previous Handling Restrictions: n/a
Page Count: 5
Previous Channel Indicators: n/a
Previous Classification: CONFIDENTIAL
Previous Handling Restrictions: n/a
Reference: 77 HONG KONG 12620, 77 JAKARTA 13467, 77 STATE 229513
Retention: 0
Review Action: RELEASED, APPROVED
Review Content Flags:
Review Date: 11-Feb-2005 12:00:00 am
Review Event:
Review Exemptions: n/a
Review Media Identifier:
Review Release Date: n/a
Review Release Event: n/a
Review Transfer Date:
Review Withdrawn Fields: n/a
SAS ID: 834535
Secure: OPEN
Status: NATIVE
Subject: IRS RULING ON INDONESIAN PRODUCTION-SHARING CONTRACTS
TAGS: ENRG, ID, IRS
To: STATE
Type: TE
vdkgvwkey: odbc://SAS/SAS.dbo.SAS_Docs/f9c29c29-c288-dd11-92da-001cc4696bcc
Review Markings:
Margaret P. Grafeld
Declassified/Released
US Department of State
EO Systematic Review
22 May 2009
Markings: Margaret P. Grafeld Declassified/Released US Department of State EO Systematic Review 22 May 2009